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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-1616

BOGUE ELECTRIC MANUFACTURING CORPORATION, EDWARD P. SCHINMAN, ROBERT S. HERWIG, WILLIAM S. GUTTENBERG and MURRAY REIFFIN,

Petitioners,

v.

HERMAN L. ZELLER, IRWIN SMALL COMPANY, a PARTNERSHIP, and BELCO POLLUTION CONTROL CORPORATION,

Respondents.

BRIEF OF RESPONDENT ZELLER IN OPPOSITION TO A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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TABLE OF CONTENTS

PAGE

Statement of Facts 1

POINT I—There is No Conflict Between the Circuits on the Measure of a Defrauded Buyer's Recoverable Damages Under the Federal Securities Laws 4

Conclusion 21

TABLE OF AUTHORITIES CITED

Cases:

Affiliated Ute Citizens v. *United States*, 406 U.S. 128 (1972) 10

Baumel v. *Rosen*, 412 F.2d 571 (4th Cir., 1969) ...13, 14, 16

Deckert v. *Independence Corp.*, 311 U.S. 282 (1940) 14

DiTomasso v. *Loverro*, 293 N.Y.S. 912 (A.D. 2d, 1937).. 6

Estate Counselling Service, Inc. v. *Merrill, Lynch*, 303 F.2d 527 (10th Cir., 1962) 6, 8, 12

Galigher v. *Jones*, 129 U.S. 193 (1889) 16

Gratz v. *Claughton*, 187 F.2d 46 (2d Cir., 1951) 18

Grodsky v. *Sipe*, 30 F.Supp. 656 (E.D. Ill. 1940) 19

Janigan v. *Taylor*, 344 F.2d 781 (1st Cir., 1965), cert. den. 382 U.S. 879 (1965) 7, 9, 10, 12, 13, 16

Jefferson Savings & Loan Association v. *Lifetime Savings & Loan Association*, 396 F.2d 21 (9th Cir., 1968) 19

Levine v. *Seilon, Inc.*, 439 F.2d 328 (2d Cir., 1971) ... 9, 10

Myzel v. *Fields*, 386 F.2d 718 (8th Cir., 1967), cert. den. 390 U.S. 951 (1968) 7, 9, 10, 13, 14, 15, 16

Oliver v. *Piatt*, 44 U.S. 333 (1845) 18

PAGE

Pappas v. *Moss*, 393 F.2d 865 (3d Cir., 1968) 13

Perkins v. *Waukesha National Bank*, 290 F.2d 912 (7th Cir., 1961) 19

Perlman v. *Feldman*, 219 F.2d 173 (2d Cir., 1955) 11

Ross v. *Licht*, 263 F.Supp. 395 (S.D.N.Y. 1967) 18

S.E.C. v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963) 16

Schoenbaum v. *Firstbrook*, 405 F.2d 215 (2d Cir., 1968) 13

Sigafus v. *Porter*, 179 U.S. 116 (1900) 5

Smith v. *Bolles*, 132 U.S. 125 (1889) 4, 5, 13

Straley v. *Universal Uranium & Milling Corp.*, 289 F.2d 370 (9th Cir., 1961) 14

Superintendent of Insurance v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971) 9

Upson v. *Otis*, 155 F.2d 606 (2d Cir., 1946) ..6, 8, 9, 10, 15, 16

Statutes:

Securities Act of 1933, Section 17(a) 9, 14

SEC Rule 10b-5, 17 C.F.R. 240.10b-5 ..9, 10, 12, 13, 14, 18, 20

Other Authorities:

Bromberg, *S.E.C. Rule 10b-5* 17

Fletcher's Cyclopedia of Corporations, Section 1343 6

Loss on Securities Regulation, Vol. 6 .....17, 18

Restatement of Restitution, Section 151 14

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BRIEF OF RESPONDENT ZELLER IN OPPOSITION TO A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Statement of Facts

This is a stockholder's derivative action for securities fraud on a corporation by controlling persons. The single issue in this case is the measure of recoverable damages for violation of the federal securities laws, when the victim of the fraud is a 75% owned subsidiary corporation, and the fraud consists of forced loans by its parent corporation, at unreasonably low interest rates, at a time when the parent was virtually insolvent and unable to borrow elsewhere. The methods complained of gave the parent use of the subsidiary's monies for inadequate compensation, unconscionable profits and other benefits from the forced

loans. The decision below outlined five areas of recoverable damages inferrable from the particular facts of this case, each subject to a rigorous measure of proof. The unanimous Opinion by Chief Judge Friendly of the Court of Appeals for the Second Circuit (petition for rehearing and rehearing *en banc* denied) states nothing more than that plaintiff, a complaining stockholder of the subsidiary, should have been given the right to prove the facts as to the items of damage potentially recoverable by the victimized corporation. The Opinion below stated carefully drawn elements which plaintiff had the burden to establish for recovery on each of the five items of damages to the subsidiary corporation which were claimed. Petitioners complain that the Court of Appeals somehow changed the law of securities fraud damages, or damages for breach of duty by a corporate fiduciary. But in substance, the Court of Appeals did nothing more than uphold a complaint, and grant to plaintiff his day in Court on behalf of the victimized subsidiary corporation.

The essential facts of this case may be reduced to a brief statement. Bogue Electric Manufacturing Corp. ("Bogue"), and the members of its Board of Directors, and the accountants for Bogue, defendant Irwin Small Company, are claimed to have violated the federal securities laws in forcing a 75% owned subsidiary of Bogue, named Belco Pollution Control Corp. ("Belco"), to loan some $315,000 to the parent corporation in 1970 through 1972, under the following conditions. The parent borrower was virtually insolvent at the time; the lender Belco had paid nearly $400,000 in value and expenses to raise the $315,000 in a public offering the year before; there was no corporate purpose of Belco to be served by the loans; the parent borrower was paying 10½% per annum and giving a first mortgage on real estate with 300% coverage to obtain smaller loans at the time; and Belco was earning some 40% per annum return on capital and had better

use for the $315,000 in cash working capital in its own business, as contrasted with a loan to its parent. Finally, the parent was using the forced financing from the subsidiary to finance the speculative carrying of the parent's 75% stock interest in Belco until Belco's over-the-counter trading price increased, thus netting the parent a substantial profit (some $97,000) on the investment being carried with a forced margin loan from the subsidiary. The salient facts indicated a flagrant abuse of fiduciary responsibility to the public shareholders of Belco who own 25% of its outstanding stock, and showed virtually a weekly "dipping into the till" of Belco by its parent whenever cash was needed in 1970 and 1971. The documentary evidence also showed fraudulent corporate "window dressing" to conceal the abuse of control and misleading filings with the Securities and Exchange Commission, when the forced loans on open account were reduced to a corporate note collateralized by an inadequate block of Belco's own shares pledged by the parent. When sources of public financing discovered the fraudulent loans in 1971, a $1,500,000 equity financing for Belco was cancelled, thus cutting off Belco from future growth as well as the current out-of-pocket damage suffered.

When the plaintiff's stockholder's derivative action was brought against the parent Bogue and the directors responsible for the fraud, Bogue was forced to seek methods for immediate repayment of the loan. This action was commenced in December, 1971, and five months later (after unproductive settlement discussions with the plaintiff), Bogue sold its 75% interest in the subsidiary to a new parent, Foster-Wheeler Corporation, and Bogue was required to pay back the forced loan at the closing of the proceeds of sale. Bogue, on the verge of insolvency, with all credit lines exhausted and several items of corporate debt in default, had no other means of repaying the loans except from the proceeds of sale. Through the abuse of

office, it turned a handsome profit on the Belco shares, repaid the illegal loan and pocketed the fair interest value thereof, and then moved to dismiss plaintiff's case. The District Court, dismissed, and the Court of Appeals reinstated the complaint.

The Court of Appeals made a searching inquiry into the proper elements of damage to Belco, which it could recover against its parent corporation and interlocking directors as a result of this gross fraud upon Belco, virtually conceded in the relevant documents. The case involved the special qualities of securities fraud practiced upon a corporation, by inducing it to issue a note and to accept shares of stock as collateral to secure the note, which was an integral part of a plan of fraud and deceit, as well as misrepresentations and omissions, practiced upon the victimized subsidiary corporation. The fiduciary obligations of the defendants under common law, recognized on many occasions in the enforcement of the federal securities laws, were fused with the normally recoverable damages for violation of the federal securities laws. It is these special kinds of fiduciary damages which Judge Friendly held to be recoverable on the specific facts of the instant case which have led the petitioners to seek certiorari from the Supreme Court.

POINT I

There is No Conflict Between the Circuits on the Measure of a Defrauded Buyer's Recoverable Damages Under the Federal Securities Laws.

The Second Circuit decision delineates the bases of recoverable damages in this case, by dividing them into their categories. First, there are the damages recoverable under the long established "out-of-pocket" rule which even petitioners concede to be a proper measure of damages in a case for federal securities fraud. *Smith* v. *Bolles*, 132

U.S. 125 (1889); *Sigafus* v. *Porter*, 179 U.S. 116 (1900). The recoverable damages under the "out-of-pocket" rule embrace the first two damage elements in the case, i.e., whether 8% per annum interest was a fair interest rate for Belco to be paid in the circumstances of this case. As the Second Circuit says (12a, Petition for Certiorari ["Pet."]) "plaintiff's first theory of damages . . . is, in essence, that the 8% note and the preceding open account debt were not worth what Belco paid for them. We cannot agree with the District Court that damage to a subsidiary from forcing it to loan money to a parent necessarily is fully compensated by the parent's paying off the note, even with a fairly liberal rate of interest, if the subsidiary was in a position to lend money at a higher rate". The facts showed Bogue was forced to pay 10½% per annum in 1971 plus a first mortgage on real estate with 300% coverage for the loan, to borrow merely $150,000 around the same time as these dangerous, and essentially unsecured notes were foisted upon Belco. The facts also showed Bogue had exhausted its borrowing powers by 1971, measured by any businesslike standard of collateral or earning power to secure repayment of further loans. The Court of Appeals then went on to delineate the type of proof required to establish that 8% per annum was an inadequate rate of interest, including a requirement that plaintiff prove Belco, "engaged in the business of pollution control, could have found borrowers and that it had funds to loan . . ." (13a Pet.). The facts presented to the Court below included the high cost of borrowing in 1970, with corporations paying effective interest rates of 15% to 20% per annum, giving effect to compensating balance requirements and "equity" sweeteners in the form of options and warrants required to secure loans during that period of "tight money". Plaintiff's first theory was merely a request that the Court allow it to prove "out-of-pocket" damages by a businesslike presentation of the actual value of money to a precarious borrower like Bogue during the relevant pe-

riod. Thus the first theory of damages upheld by the Circuit Court is entirely within the "out-of-pocket" rubric which petitioner concedes to be applicable to the instant case. That is reason enough to uphold the decision to give plaintiff his day in Court.

Plaintiff's second theory of damages, the cost to Bogue of obtaining the monies elsewhere, was held to be "the mirror image of the first", because "it looks to the seller's gain rather than the buyer's loss" (Pet. 13a). The second theory was held to be part of the "out-of-pocket" concept too, even though "disgorging" was part of its basis.

Plaintiff relied on *Upson* v. *Otis*, 155 F.2d 606 (2d Cir., 1946); *Fletcher's Cyclopedia of Corporations*, Section 1343 and *DiTomasso* v. *Loverro*, 293 N.Y.S. 912 (A.D. 2d, 1937), to support a searching inquiry into the value of money as a commodity to a defalcating corporate fiduciary in 1971. The question presented by plaintiff was: What would have been a proper interest rate in terms of what Belco would have demanded in an arms-length loan to Bogue at the time of these fraudulent loans, taking into account all the factors that a knowledgeable lender, aware of market conditions, and freely exercising its discretion, would bring to bear on such a substantial and risky business transaction with Bogue? Plaintiff asked merely that the Federal Court in a securities fraud case, but sitting in equity because fraud upon a corporation was involved, review the loan transaction with respect to a fair interest rate in a practical and businesslike manner. Cost of the money to Belco, risk, security, term, general money market conditions, and the unavailability of alternative financing to Bogue were all argued as being relevant to a just result on the first two theories of damages. Rather than resulting in a conflict with the Tenth Circuit decision in *Estate Counselling Service Inc.* v. *Merrill, Lynch, Pierce, Fenner & Smith*, 303 F.2d 527 (1962), the Second Circuit cited such decision in support of its analysis of actual value of

the commodity parted with by the victim of securities fraud (Pet. 12a). The underpinnings of the Second Circuit's Opinion herein are the very cases which petitioner claims to be in conflict therewith—*Janigan* v. *Taylor*, 344 F.2d 781 (1st Cir. 1964) cert. den. 382 U.S. 879 (1965), and *Myzel* v. *Fields*, 386 F.2d 718 (8th Cir., 1967). As will be seen *infra*, these decisions in other circuits were the basis of plaintiff's argument below and were adopted by the Second Circuit as sound precedents for analyzing the special facts of the instant case.

The Court of Appeals then turned to plaintiff's next claim (the "third theory", Pet. 13a), that there was a hidden profit to Bogue in the transaction which it should be required to disgorge. The hidden profit arose because Bogue pledged 150,000 shares of its subsidiary's stock with the subsidiary itself, as collateral for the loans of $315,000. As a result of being able to force this loan, which was a form of margin borrowing, upon the subsidiary corporation, Bogue was able to retain these 150,000 shares notwithstanding other grave financial pressures upon it. It was enabled to wait for a rise in the market value of these unregistered (under the Securities Act of 1933) and unliquid shares, which were difficult to pledge with an arms-length lender, and could only be sold as part of a total disposition of control in Belco. Such rise in market value occurred within a year, in the spring of 1972 (five months after this case was started), and Bogue was thus enabled to sell the 150,000 shares put up as collateral for $412,500 to Foster-Wheeler Corporation, as part of a disposition of all of its other shares in Belco which had not been pledged as collateral. This forced margin loan of $315,000 was valuable financing to Bogue for a profitable transaction, which Bogue, who was insolvent and in a severe liquidity crisis, could not otherwise have obtained. The difference between the $412,500 received for the 150,000 shares, and the $315,000 repaid to Belco for carrying them an additional year, was a net profit of $97,500 to the parent cor-

poration. The documentation presented to the Circuit Court showed that Belco, who was forced to accept the 150,000 shares as collateral, was the de facto owner of such shares from the date of pledge, because the parent's note was essentially uncollectible and they were the only realistic source of ultimate repayment. Plaintiff claims that Belco should have all the profit from the sale, because Belco's forced loan gave Bogue the breathing time, without a "distressed sale" of these shares (which being unregistered under the Securities Act of 1933 were not readily pledgeable). Bogue, with no genuine risk, could wait until Belco became profitable, and the parent thus obtained a handsome profit on the shares by placing the risk on the subsidiary. Plaintiff claims that the profit of $97,500 belongs to Belco, in addition to the realistic rate of interest described above. In sum, a trustee made a private profit on the trust estate, because it obtained margin financing that no broker or bank would give it. The trustee was like any other fiduciary converting the property of the trust estate, and required to disgorge his illegal profit. See *Upson* v. *Otis*, *supra*. There was no bargain with Belco as to which it was seeking the benefit, as was rejected in *Estate Counselling Service, Inc.* v. *Merrill, Lynch, etc.*, *supra*. There was only theft by a fiduciary and profit to him sought to be restored.

On this third theory of damages, the Circuit Court set forth strict elements of proof, requiring a showing that Belco was harmed, "that Bogue required the forced loan to keep alive, and that it had no other means of doing so except by selling, not pledging some of its Belco shares; and that an earlier sale would have resulted in a lower price for the stock". (Pet. 14a) Under this strict burden of proof (which plaintiff feels confident it can meet nonetheless), did the Court of Appeals establish a new theory of recoverable damages under the securities acts, and did it create a conflict among the Circuits by such theory, as petitioners contend?

An examination of the cases relied upon by the petitioners establishes that petitioners' claim of conflict in the Circuits, or novelty in Judge Friendly's theory, is wholly imaginary. In sum, petitioners argue that defrauded buyers of securities (such as Belco who was forced to take its parent's note and a pledge of its own stock to secure the uncollectible note) are not entitled to the same measure of damages as defrauded sellers. Sellers can recover future accretions to the property obtained by the fraudulent party, concede the petitioners, but it is claimed that buyers cannot recover such accretions. The theory must fall of its own weight, and shatters completely when measured by *Janigan* v. *Taylor*, *supra*, and *Myzel* v. *Fields*, *supra*, upon which petitioners themselves rely (Pet. 6).

Abuse of corporate trust relationships is well within Rule 10b-5 if deception in the use of securities is established. *Bankers Life and Casualty Co.*, 404 U.S. 6 (1971). Does the rule of *Upson* v. *Otis*, *supra*, where the Second Circuit long ago stated both the Delaware and New York rules for damages recoverable from defalcating corporate fiduciaries, require any modification in the context of a Rule 10b-5 claim under the 1934 Act or a Section 17(a) claim under the 1933 Act? We submit that it does not, because it is well settled, even in Rule 10b-5 cases, that a defrauded seller of securities can recover not only the difference between the stated and the actual value of what he has received at the date of sale, "but added profits which the buyer has realized through accretions in value subsequent thereto." *Levine* v. *Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971). In the instant case there was an accretion in value to Bogue with each withdrawal because cash was worth so much more than its face value in 1970 and 1971. Moreover, Bogue admitted in its papers that it had prior offers for Belco's shares from 1971 onward and rejected them to pursue further speculative gain as Belco's profits increased—all at Belco's risk.

Proceeds which the seller (or lender of property) would have realized if it had retained the property for a reasonable period after the fraudulent transfer may be considered in determining the proper recovery. *Myzel* v. *Fields*, *supra* at pp. 744-747; *Janigan* v. *Taylor*, *supra* at p. 786, followed in the Second Circuit in *Levine* v. *Seilon, Inc.*, *supra*. The rationale for the favorable treatment of defrauded sellers of securities (or anyone "induced to *convey property* to the fraudulent party") was stated by Chief Justice Aldrich in *Janigan*, as follows:

> "It is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them . . . it is simple equity that a wrongdoer should disgorge his fraudulent enrichment." (p. 786)

Thus, in the context of sellers of securities, several circuits have applied fundamental equity principles of damages, applying the concept of unjust enrichment and recovery of the highest intermediate value of securities wrongfully obtained during the period of unlawful conversion. Moreover, *Janigan* v. *Taylor*, *supra* at p. 786, addressed itself to all sellers of property, not just to sellers of securities. See approval of *Janigan* in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972). Thus *Upson* v. *Otis*, *supra*, is already a part of the law of Rule 10b-5, and requires recovery of the private profit on sale of the collateral made by a disloyal fiduciary.

By taking the bare facts of the jurisdictional presentation in this case, i.e., that Belco "bought" Bogue's note and the shares of Belco stock deposited by Bogue as collateral, the petitioners wish to treat Belco solely as a "buyer" of securities and limit its recoverable damages on the transaction to the price paid for the securities, with interest at the 8% rate volunteered by the petitioners. This mechanical approach to the issue of the proper

measure of recovery, once federal jurisdiction has properly attached, is inappropriate. Even literal application of the phrase "out-of-pocket" meant some $400,000 to Belco because that was its net cost (after commissions and expenses) for $315,000 in cash through a public offering the year before, and the value of such assets had increased in 1971 because of "tight-money". Petitioners' approach forces the federal courts to ignore the realities of the money markets when it is money that has been misappropriated, rather than shares or timber or steel. See *Perlman* v. *Feldman*, 219 F.2d 173 (2d Cir. 1955) for recovery of the corporate opportunity to sell steel in the Korean War "grey market" implicit in the valuation of control shares sold at a substantial premium. *Perlman* applies both to the lost opportunity to earn a realistic interest rate herein (first and second theory), the profit diverted by Bogue by using Belco's money to finance margin borrowing on 150,000 shares of stock (third theory of damages), and the lost opportunity to earn a fair return on its cash capital, i.e., 40% was being earned in its normal business. (See fifth theory, *infra*.)

While Belco may have been a "buyer" of securities for jurisdictional purposes, for purposes of the practical business substance of its claim here, it was a "seller" of money. And it was a "seller" of money to a buyer with little ability to repay in a tight money market, who forced such sale by use of its control over an interlocking board of directors. Belco's announced business in its recent prospectus to the public did not include making high-risk loans to control persons. Belco said it was in the waste treatment business. A Federal court should not use a jurisdictional "buyer"-"seller" framework to evaluate the substantive rights of recovery for a plaintiff once he has made out his case showing deception and overreaching within the ambit of the federal securities laws. The Court, rather, should give just compensation for deprivation of property within the traditional framework of "simple

equity". *Janigan* v. *Taylor*, *supra*. The decision in the District Court had the anomalous result of making a misappropriation of cash more attractive to fiduciaries than removal of less liquid assets—8% per annum might be too good a deal for defendants like Bogue to pass up again.

Judge Friendly's decision states "We do not consider the . . . cases . . . establish any such bright line between defrauded sellers and defrauded buyers as defendants [petitioners] urge." (Pet. 11a). He then states the legal reality: "The reason why the remedy [disgorging wrongful profits] has been applied for the benefit of defrauded sellers but not of buyers is not any decisive legal difference but the difficulty generally confronting the defrauded buyer in showing that the fraudulent seller has in fact reaped such a profit." (Pet. 12a).

Even the cases cited by the petitioners go further in dealing with the substantive issues of recovery than petitioners claim. *Estate Counselling Service, Inc.* v. *Merrill, Lynch, etc., supra*, at p. 532, urged by petitioner, does not bar a plaintiff from recovery under Rule 10b-5 of customary damages for an intentional tort, i.e., damages which are naturally and proximately caused by the fraud. The case holds that the defendant "is bound to make good the loss sustained—such moneys as the plaintiff has paid out, with interest, and any other outlay legitimately attributable to the defendant's fraudulent conduct" (p. 533). The case barred recovery only of the plaintiff's anticipated profits on a proposed short term trading transaction with his stockbroker, which he never completed, treating this as the "expected fruits of an unrealized speculation," which are concededly unrecoverable. But Belco's earning a realistic interest rate, or earning 40% a year operating its own business was not an unrealized speculation—the forced loan to an expiring parent corporation was the speculation, a transaction not in the ordinary course of business, inadequately collateralized, and a very dangerous venture.

Bogue's earning $97,500 on the shares left with Belco was also a speculation by a forced margin loan; that transaction *was* realized but Bogue kept the profit. The Supreme Court decision in *Smith* v. *Bolles*, *supra* also relied on by petitioners, merely restricts recovery of damages to the natural and proximate consequences of the act complained of, a principle which would be carried out by application of the concept of unjust enrichment, and the conversion rule, in the instant case.

The issue tendered by petitioner is whether a Federal Court should consider a Rule 10b-5 case for securities fraud on a corporation only up until the point where damages in the securities transaction are shown, then close its ears to any further elements of damages recoverable because the securities transaction also involved overreaching by the directors.* In other words, defendants are arguing that the federal courts should not give complete and entire relief on a cause duly brought before them. *Pappas* v. *Moss*, 393 F.2d 865 (3rd Cir., 1968), and *Schoenbaum* v. *Firstbrook*, 405 F.2d 215 (2d Cir., 1968) are all contrary to such a limiting principle. The simplistic argument that all that left Belco's pocket was cash, and therefore $315,000 (plus 8% interest) is the limit of its recoverable damages, was the beginning and end of petitioners' case.

In the instant case it is evident that Belco was not voluntarily in the business of lending money and the defendants merely paying 8% per annum interest for the use of its money neither undid a serious violation of Rule 10b-5 nor put an end to its damages. We submit that in addition to Judge Friendly's Opinion herein, and *Janigan* v. *Taylor*, *supra*, the Eighth Circuit's reasoning in *Muzel* v. *Fields*, *supra* (followed in *Baumel* v. *Rosen*, 412 F. 2d

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* Valuing the cash at its actual cost and charging a realistic interest rate (first and second damage theories) would come within the purview of even this limiting rule.

571, 575 [4th Cir., 1969]), was dispositive herein. Petitioners erroneously urge that because Belco brought a cause of action into the federal court under Rule 10b-5 as a "buyer" of securities, it must retain such status throughout the action, with all its limitations, on into the final decree of relief, arguing that the federal courts will be flooded with corporate mismanagement cases (Is fraud merely mismanagement to petitioners?) unless the recoverable damages are restricted. But *Myzel* states that the "nature of the relief sought, not the statute which creates the right, determines the legal or equitable remedy" (p. 741). *Myzel* also indicates that although Belco may be a "buyer" under Rule 10b-5 and Section 17(a) of the 1933 Act, it is entitled to both equitable and legal relief to the fullest extent once it establishes its case on the issue of liability, citing the well-known principle in the field of securities regulation that: "The power to *enforce* implies the power to make effective the right of recovery afforded by the Act." *Deckert* v. *Independence Corp.*, 311 U.S. 282, 288 (1940); *Straley* v. *Universal Uranium & Milling Corp.*, 289 F. 2d 370, 373 (9th Cir., 1961). Equitable doctrines of restitution are well accepted in Rule 10b-5 cases, including Section 151 of the Restatement of Restitution, relied on in *Myzel* v. *Fields*:

> "Where a person is entitled to a money judgment against another because by fraud, duress or other consciously tortious conduct the other has acquired, retained or disposed of his property, the measure of recovery for the benefit received by the other is the value of the property at the time of its improper acquisition, retention or disposition, or a higher value if this is required to avoid injustice where the property has fluctuated in value or additions have been made to it." (cited at p. 743, *Myzel* v. *Fields*, *supra*) "Where fungibles such as corporate stock [or, we submit, ready cash during a period of tight money] have no ready

> market value and actually fluctuate in value, different measures or modified versions of the same theory become more appropriate." (*Myzel* v. *Fields*, *supra*, p. 745).

The out-of-pocket damage theory, urged by petitioners is neither disregarded nor restricted in *Myzel* v. *Fields*, *supra*, but the complicated tailoring of a corporate pocket is examined within the Court's broad power to give complete and full relief, implicit in the fusion of law and equity. The Eighth Circuit enunciated the applicable principle as follows:

> "When stock in a corporation has not figured in the markets, and there have been no sales or dealings therein, its actual value must be determined at the fair price which a person who desires to buy would be willing to pay, taking into consideration the orgiinal capital, how far there has been profit or loss in the business carried on, the assets and liabilities, the future prospects and everything that goes to affect the value of the shares of stock." (*Myzel* v. *Fields*, *supra*, p. 745).

By the same token, the value of working capital to a small start-up corporation which has recently gone public, which has recently paid $1.26 in cash and equity value for every $1 of this working capital raised from the public, and which is earning 40% per year for *all* shareholders, on its invested capital at the time of the forced loans, should be measured in equity by the same detailed analysis used for determining the value of any commodity at the time of wrongful deprivation. Thus, apart from determining a realistic interest rate, the instant case also has other damage elements in the private profit which a fiduciary obtained on trust assets (plaintiff's third theory) and loss of a 40% per annum internal corporate opportunity (fifth theory, Pet. 15a). In addition to *Upson* v.

Otis, supra, the federal courts have approved for decades a rule of damages for conversion of stock or other property measured by the price at the time of conversion or the highest intermediate value reached within a reasonable time after notice of the conversion, whichever is greater. *Galigher* v. *Jones* (cited in *Myzel, supra*), 129 U.S. 193, 200 (1889) states:

> "Other goods wrongfully converted are generally supposed to have a fixed market value at which they can be replaced at any time; and hence, with regard to them, the ordinary measure of damages is their value at the time of conversion, or, in case of sale and purchase, at the time fixed for their delivery. But the application of this rule to stocks would, as before said, be very inadequate and unjust."

In more recent years, the Supreme Court, in the famous decision where it instructed the Circuits to construe the federal securities laws flexibly, and not technically and restrictively, in order to effectuate their remedial purposes, commented:

> "There has also been a growing recognition by common-law courts that the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as advice and securities, and that, accordingly, the doctrines must be adopted to the merchandise in issue." (*S.E.C.* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 [1963].)

Myzel v. *Fields, supra,* and *Baumel* v. *Rosen, supra,* cite with approval the holding in *Janigan* v. *Taylor, supra,* that "it is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them." The Second Circuit herein merely followed the unanimous views of the other Circuits who have considered these damage issues.

The authoritative treatises of *Bromberg* and *Loss* in the Rule 10b-5 field also support plaintiff's position herein, that the merchandise in issue must be intensively evaluated—what was money worth in general in 1970 and 1971 and in this particular context? Professor Bromberg's *S.E.C. Rule 10b-5*, at p. 227, after identifying the out-of-pocket rule applied herein for defrauded buyers, states that:

> "Prevailing defrauded sellers have done better by virtue of a constructive-trust approach, which gives them whatever profits the buyer has garnered on resale. This is plainly appropriate where the resale is immediate or under active contemplation, but is more doubtful, though still used, when the resale is much later and was not planned at the time of sale. Unless the fraud is relatively severe, a fairer measure would be the difference between the price and value at the time of the transaction, in symmetry with the buyer cases . . ."
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> * * *
>
> "A defrauded issuer is not limited to cancellation of the securities or recovery of their par value, but may recover their fair value at time of issuance. By analogy to the seller cases, the issuer may be entitled also to post-issuance profits of the recipients." (pp. 227-229)

What this authority is saying is that the federal courts have authority to give a complete and full remedy for violation of the securities laws, whatever form such violation may take, and that no distinction should be made in framing a decree of relief as between someone who came into court, for jurisdictional purposes, as either a "seller" or "buyer" of securities. *Loss on Securities Regulation*, Vol. 6, p. 3923, takes essentially the same position on the measure of damages, stating that, for complaining sellers of securities where there is no market for the securities,

> "fair value is to be determined from all of the pertinent circumstances both for a reasonable time before the sale

> and after it . . . If there can be no exact calculation . . . the wrongdoer cannot complain if a reasonable approximation is reached." (citing *Ross* v. *Licht*, 263 F.Supp. 395, 410 [S.D.N.Y. 1967], and on the approximation point, *Gratz* v. *Claughton*, 187 F.2d 46, 51-52 [2d Cir., 1951])

Professor Loss then goes on to state:

> "Presumably the same measure of damages will be applied *e converso* in so far as *buyers* may be permitted to sue under Rule 10b-5 or Section 17(a) of the 1933 act (see *Janigan* v. *Taylor*, *supra*)."

Thus it appears there was no reason for the Second Circuit to make a distinction between Belco's status as a "buyer" of Bogue's note, or as an unwilling "seller" of Belco's working capital, in fashioning an appropriate measure of relief, consonant with established principles of restitution, value of a converted commodity (or diverted opportunity) and unjust enrichment, as historically enforced by the federal courts. Petitioners here have overlooked the traditional duty of a court of equity, in a Rule 10b-5 case or any other action, to fashion a remedy appropriate to the wrong committed.

The principles which govern herein are as ancient as those in *Oliver* v. *Piatt*, 44 U.S. 333 (1845). There a trustee misappropriated trust assets and involved them in other property. The original assets were later repurchased for return to the trust, but the beneficiary elected to trace the new more valuable property and was allowed to do so. The Court stated that the trustee should not be permitted to avail himself of his own wrong, and if he had made a profitable investment of the trust fund, to appropriate the profit to his own benefit by a repurchase of the trust fund, and to charge the loss or deterioration in value if any against the trust. The ancient rule in equity is "that all the gain made by the trustee, by a wrongful appropriation of the trust fund, shall go to the *cestui que trust*, and all the losses shall be borne by the

trustee himself." This case is cited in *Perkins* v. *Waukesha National Bank*, 290 F.2d 912 (7th Cir., 1961). For further applicable trust cases, see *Jefferson Savings & Loan Association* v. *Lifetime Savings & Loan Association*, 396 F.2d 21 (9th Cir., 1968). See also *Grodsky* v. *Sipe*, 30 F.Supp. 656, 661 (E.D. Ill. 1940), which states:

> "Among the obligations of any trustee . . . are those to use care and diligence in the discharge of his functions. For the failure to do so, he is liable even when no wrongful intent appears. He may be liable for neglect because answerable for property actually lost through want of care and prudence and for moneys which he might have received if he had exercised due care, prudence, and judgment in his dealings with the trust estate."

Finally, in a transaction where one party, Bogue, controlled both sides of the bargain, its subsequent volunteering of 8% per annum after a suit was prosecuted, is reason enough to see if the facts required a more substantial payment. Even the 8% per annum was not sufficiently proven, being shown only in an affidavit based on average outstanding balances, without any opportunity for plaintiff to make inquiry as to the validity of the computations.

The fourth element of damages herein seeks recovery of consequential damages in that a substantial public securities offering for the benefit of Belco was terminated in 1971, because of the improper overreaching of the insider defendants and the unwillingness of underwriters to sanction continuation of these improper loans in an underwriting for which they were being responsible. This element of damages to the corporation is of course a question of fact to be proven, and while the motion papers showed that such claim has substance, it should be evaluated in an overall hearing on damages. Judge Friendly required that plaintiff "must establish the causal nexus

with a good deal of certainty" (Pet. 14a), and further set out strict guidelines for any recovery on this damage theory (Pet. 15a). There is no reason why potential corporate growth from another public offering, forestalled by the overreaching of the defendants, should not be a recoverable item as against these fiduciaries. The growth of the company at a substantial rate each year is no different from the reasonable growth of any other trust fund, and plaintiff should have his day in court to show the underwriting negotiations, the nature of the proposed offering and that the underwriters refused to handle the transaction as a proximate result of these continuing loans to insiders of Belco. And further as required by the Circuit's Opinion, "that Belco could have used the proceeds in a manner which would have increased per share earnings" (Pet. 15a). In substance, plaintiff should have the right to prove as compensable damages under the 1933 and 1934 Acts that defendants' conduct violative of the securities laws and their fiduciary duties placed a definable, substantive cloud upon Belco's ability to raise money from the public, and prevented putting such money to productive use at or near the return on capital established for 1971. The Circuit established a similar tight rule of proof for plaintiff's fifth theory, of consequential damages for loss of the opportunity to earn this 40% per annum return on capital even on the $315,000 pulled out of the business by Bogue's overreaching (see Pet. 15a).

At bottom, the decision of the District Court had to be reversed by the Second Circuit because it made Rule 10b-5 a remedy which requires the courts to ignore economic reality and restrict their Rule 10b-5 judgments to legal interest on liquidated claims. When the violation of federal law occurs in the context of fiduciary duties, such a rule could not be allowed to stand.

CONCLUSION

The Petition for a Writ of Certiorari should be denied, because there is no conflict in the Circuits on the damage theories delineated by the Second Circuit, and the instant case goes no further than long established precedents applicable to securities fraud practiced upon a corporation by controlling persons. Petitioners were caught with their hands "in the till", and when they tried to replace the monies taken, they continued to take a selfish, short-sighted view of all the damage they had done to Belco, and all the profit they had reaped for themselves.

Respectfully submitted,

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